DOW THEORY LETTERS INC.

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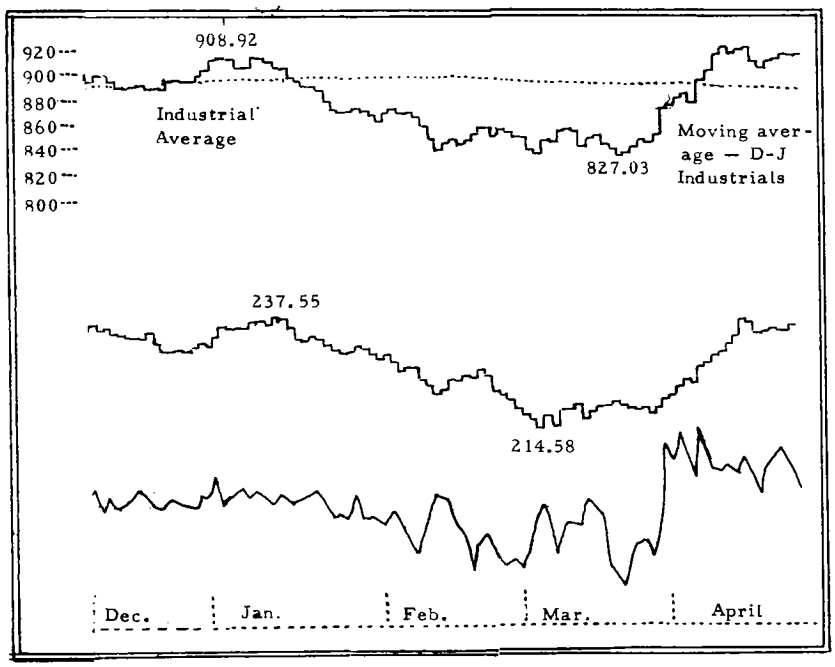
THE MARKET: With the London market at new highs, I thought the latest (April 20) comments by the authoritative London Economist were particularly significant. I thought they were significant since almost everything the Economist said about the London market can be applied to the current explosion in the U.S. market.

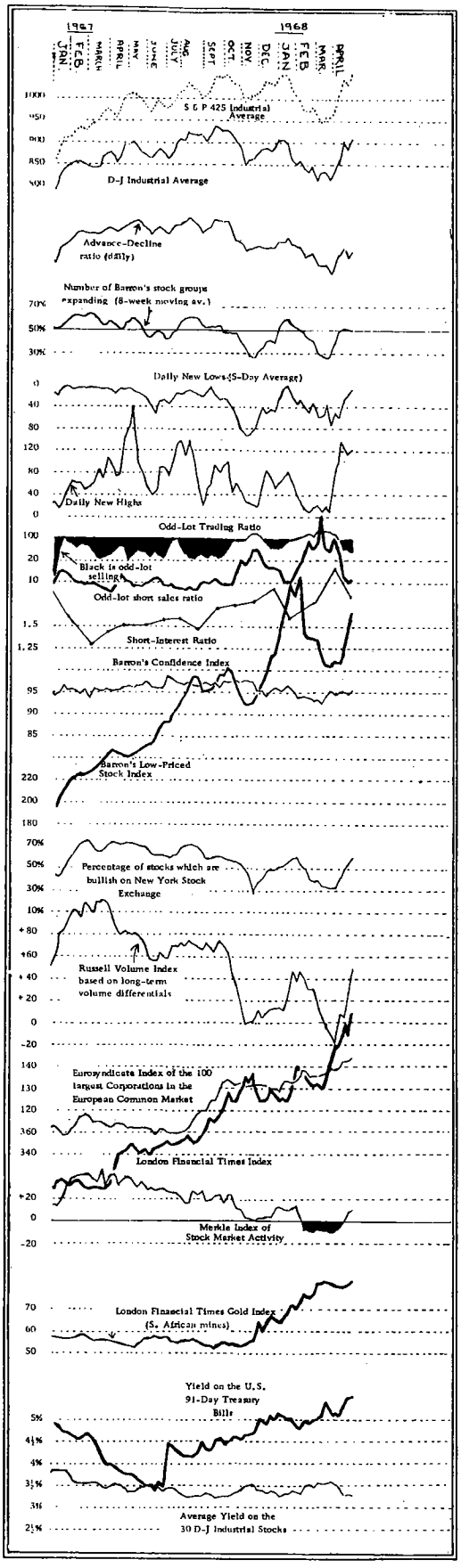
"But this remains a political market," says the Economist, "the investing public is convinced that this Government cannot control inflation, so that equities are the only safe haven, whatever the short-term economic or commercial prospects. Even a wealth tax would affect only a minority of shareholders.....Whatever economists say, the equity market is a refuge and a way of life. But you might just as well try to predict the future course of prices of paintings as of shares; the two are apparently being bought as touchstones of value more real than money."

* * * *

To turn to the U.S., the fact is that this nation has become a titanic ship without a rudder. We have a lame duck President whose influence on Congress has practically disappeared. We have a Congress which has an eye on the coming election and is therefore going to be influenced more by what the voters would like than what "is right." We have a war going which has expanded "out of control," and a possible series of negotiations which we are approaching more out of weakness than strength. We have a shaky currency which is being battered by an interminable series of balance-of-payments deficits, a currency which happens to be the world's leading reserve currency. We have a group of creditors (the European Central bankers) who are breathing down our necks, after having given us an ultimatum regarding getting our fiscal house in order.

In the face of all these pressing problems, we have an investing public which has been conditioned by 25 years of prosperity and inflation. It is a public which is firmly convinced that "in the end, everything will be worked out successfully by Washington," and that prices of stocks and everything else will be higher a





 year from now than they are now ("Hasn't this always been the case.").

This same public does not believe in primary bear markets (the fact is, they have never seen one). For twenty years they watched periodic reactions during the great 1949-1966 bull market. Following each reaction (regardless of how frightening the slide may have been at the time) the market reversed itself and ultimately pushed to new all-time highs. In the present instance, the public is convinced that the decline which began at 995.15 on the Dow (February, 1966) is nothing more than a repeat of 1953, 1957, 1960 or 1962. The public believes that as soon as Vietnam is settled, as soon as our monetary problems are coped with, the market will be on its way to new highs again.

And that is exactly the way the public (and the market) acted in late-March and April when President Johnson announced his decision not to run and when he stated that he wants to negotiate the war away. The market spurted under the pressure of the greatest volume of buying in New York Exchange history. "Everything's going to be all right" was the psychology which swept Wall Street, "Get in before it's too late."

But primary bear markets do not work like that. The Averages, during a bear market, do not reverse and go to new highs when the right button is pushed. Primary bear markets begin when the preceding bull market ends. And a primary bull market ends when the Averages have discounted and reflected the best that can be seen ahead for years to come. That was the meaning of the 995.15 historic high of February, 1966. That 995.15 peak represented the best that the Dow could see ahead. The market was saying that from then on, subject to periodic upward reversals, the trend of American business would be down, and that it would continue down until the bear market had fully run its course.

One might argue that the recent March low may have represented the bottom of the bear market. Perhaps the March low represented the worst that the market could see ahead. While that is always possible, I have reasons to doubt this thesis. Consider this: the 1949-1966 bull market lasted 17 years; it was the greatest and longest bull market in history. It is logical, therefore, to believe that this 17-year bull market will be followed by a classic three-phase bear market. In terms of length, the bear market can be expected to last 1/3 to 1/2 as long as the preceding bull market which would give us a minimum of 5 years or until around 1971. In terms of extent, most bear markets have wiped out at least half of the gains of the preceding bull market. If this were to occur between now and 1971, we could expect the Dow to decline to at least the 530 level, which would represent a correction of roughly half the gains from 1949 (161.60 on the Dow) to 1966 (995.15 on the Dow).

That is what Dow's Theory tells us to expect. The Theory tells us that the tide comes in (bull markets) and the tide goes out (bear markets). It tells us that no tide ever comes in forever and no tide ever runs out forever. It tells us that bear markets follow bull markets as the night follows the day, and that just as surely, bull markets follow bear markets. But Dow's Theory does not tell us how the tide will come in or how it will run out. It does not predict in a bull market, for instance, that there will be an Eisenhower heart attack, a Korean war, a Sputnik, an Egyptian closedown of the Suez canal. And it does not tell us that there will be a bear market with a Vietnam war, a gold crisis, a rare Presidential decision to withdraw, or a world attempt to create paper gold.

What Dow's Theory does tell us is that once the tide turns up or down, it will run (subject to all kinds of temporary interruptions) to conclusion. It tells us that during great bull markets, every conceivable type of scare and interruption (i.e. reaction) serves to keep the bull market strong, while shaking out the weak holders. And it tells us that during great bear markets we can look for all sorts of unexpected events to bring in new buyers, thereby keeping stocks in weak hands and extending the bear market. And just as a bull market which has been prolonged and prolonged will finally express itself fully by "blowing its top" on the upside, so a bear market which has been extended and extended will ultimately express itself by crashing on the downside. This is why I believe that this market is headed for major trouble during the several years ahead.

TECHNICAL POSITION: There is a great deal of misunderstanding regarding what the "technical condition" of the market means. Actually, the technical condition refers to the underlying psychology of the market at any given time. Analysts usually attempt to measure this psychology or technical condition through the use of numerous technical tools. Some of these tools are the odd-lot studies, the short interest ratio, the volume, number of investment services bullish or bearish.

It should always be understood however, that the market't technical condition is to be applied within the framework of the prevailing primary trend. Thus, if a primary bull market is in force, the technical condition of the market may be of great aid in deciding when an upward primary leg is weakening and about to top out. Or the technical condition can be useful during a bull market correction in attempting to find the area in which a bull market correction is bottoming out. But the technical condition of the market should never be used alone when attempting to identify the actual turn from primary bull to primary bear market or from primary bear to primary bull market.

The actual turn of the primary trend entails a good deal more than an analysis of the technical condition of the market. The identification of the primary trend includes a study of the three (psychological) phases, yield studies, duration and extent of the primary movement, level of margin accounts, volume, the pattern of the Averages, etc.

At the recent March, 1968 lows, the technical condition of the market was strong. It was calling for a reversal or rally of indeterminate duration and extent. When the peace news and the news of the President's decision not to run hit the headlines, the market turned up violently, propelled by avid buyers and a "sold out" technical condition. In other words, technically, the market had gotten ahead of itself on the downside, too many investors had turned too bearish, and a rally was overdue.

But the point is that the strong technical condition of the market in March, 1968 did not imply that a new bull market was in the making. When the technical underpinnings of the market are particularly strong, then even during a bear market some spectacular upside action can be expected. Often, important upside "resistance points" will be temporarily bettered, thereby reinforcing the optimistic outlook of the bulls. And just as mass psychology and the action of over 20 million investors can produce false bear signals (as per 1957 or 1962) during a primary bull market, so the frenzied buying of over 20 million investors can produce false bull signals during a bear market.

With the bettering of the January 8, 1967 high of 908.92 last week by Industrials, it remains for the Rails to better their comparable peak of 237.55. If this occurs, the two Averages will have rallied from 1968 lows and bettered preceding secondary highs. This will be considered by many as a bull signal, but I warn readers not to accept such a potential "signal" as valid.

AS THE FACTS COME MARCHING IN: Stated Federal Reserve Board member Andrew Brimmer last week, "The optimism generated by the President's New Year's message is rapidly losing its glow." Brimmer, normally a "pour on the greenbacks" liberal, was referring to the outlook for the U.S.'s balance-of-payments. The hoped-for reduction in the deficit, noted Brimmer, is rapidly becoming more dream than reality.

In response to mixed odds for successful negotiations on Vietnam, in response to the fuzzy prospects for a tax increase, in response to the growing crisis of the cities, the Reserve Board last week boosted the U.S. bank rate to the highest level since 1929—to 5½%. The prime rate or the rate which the banks charge their top-rated customers promptly rose to a whopping 6½%. Money rates across the country, from Treasury bills to bank certificates of deposit, adjusted sharply upwards.

Meanwhile, Federal Reserve Board Chairman Martin mulled over what our foreign creditors (the Central Bankers who attended the Stockholm meeting) expect of us. Martin knows that the Central Bankers are not getting the deflationary measures which they demanded of us. And he knows that those same bankers must now be fidgeting and wiping their respective brows at the prospect of further deterioration of the world's leading reserve currency, the U.S. dollar.

In another urgent request for a tax boost, Martin warned that the U.S. was "in the midst of the worst financial crisis since 1931." Martin stated further that if he thought a dollar devaluation was inevitable, "I probably would quit my job." But he added that it is "up to me to stay and fight to the last ditch." All of which were obviously sour words from Mr. Martin, since only a few months ago he was denouncing gold as a barbaric relic. But now, under pressure from our creditors, he is vowing to fight to hold the U.S. currency unit at its classic value of one dollar equalling one thirty-fifth of an ounce of gold. Thus he is chastising the nation and Congress not out of strength but weakness.

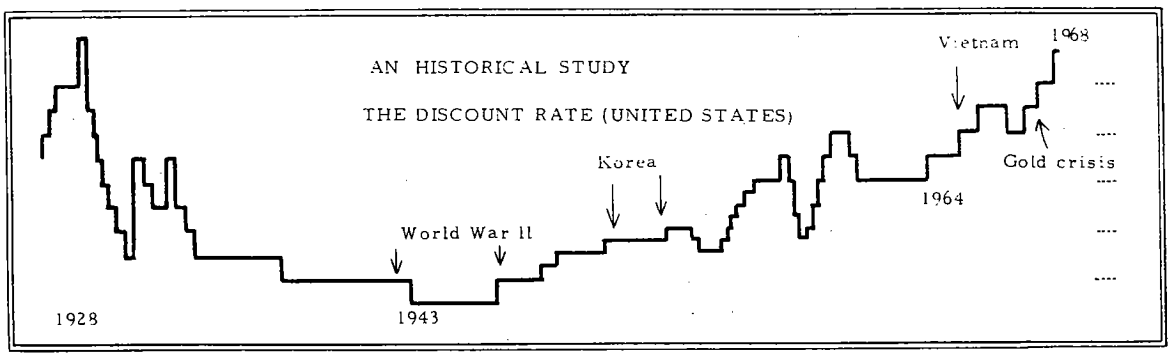
The New Deal. The Fair Deal. The New Frontier. The Great Society. Now what? No one knows what slogan will tag the next Administration. But if recent history is any guide, chances are high that the coming quadrennial period will see no end to the proliferation of new Federal programs. And if tradition holds, most of the new programs in coming years will grow in scope and cost—and few will be terminated.

Meanwhile other voices are pointing out that even if the Vietnam war ends, the chances of continuing U.S. deficits are rather excellent. For instance, note this little squib from the front page of the April 22 Wall Street Journal. If the war ends, say many experts, the $27 billion now being spent in Vietnam will rapidly be switched to spending on our besieged cities. This was also pointed out last week (April 22) in a front-page story in the Wall Street Journal. "Even if the war ends in Vietnam," Gottfried Haberler, Professor of International Trade at Harvard was quoted as saying, "I don't believe we'll see a substantial improvement in the balance-of-payments." Haberler continued, "One reason that I'm not very hopeful about prospects for the dollar is that even if peace comes, total spending would be unlikely to decline, and it very well might increase instead."

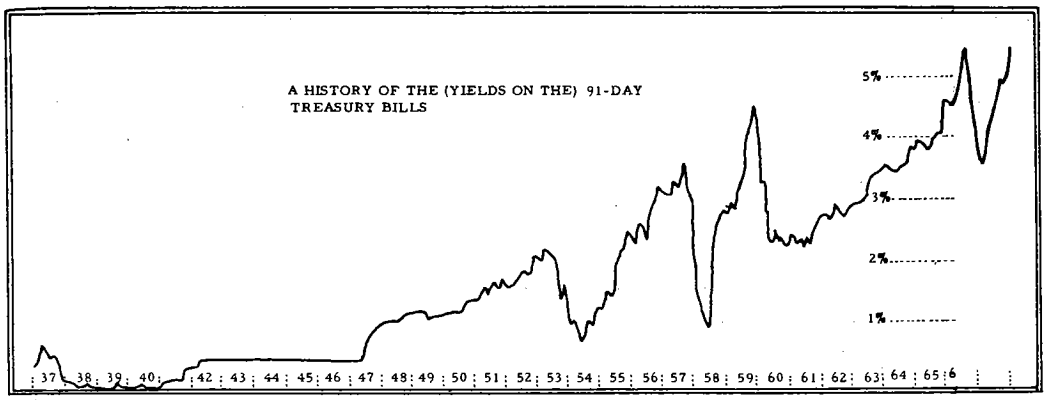
The fact is that Vietnam or not, the U.S. has been running deficits year after year after year. For instance between 1950 and 1956 the U.S. deficit averaged $1 billion per year. In 1958 the deficit jumped to $3.4 billion, and during 1959 and 1960 the deficit rocketed to roughly $3.9 billion. Then came Vietnam and more of the same.

Thus our European creditors, skeptical and anxious, are waiting to see if by some miracle the tide of deficits will be reversed. Some wag once referred to a second marriage as "a triumph of hope over experience." I would guess that our creditors view the chances of a no-deficit year in the U.S. balance-of-payments in much the same way.

MONEY, MONEY: Talk is interesting, but when it comes to actually understanding what is going on, I like the visual impact of charts. I believe the two accompanying charts are "worth a thousand words." The first chart shows the history of the U.S. bank discount rate from 1925 to the present. The picture is self-explanatory.



Starting with the 1/2% bank rate of late-1942, we see the results of 28 years of spending, wars, Government give-away programs and fantastic deficit-financing. The direction of the "money thermometer" (i.e. the bank rate) has been pushing up and up. As of last week, the Fed finally boosted the rate for the third time since late-1966 to the highest level since 1929. And the implication is clear. The bank rate is going to continue pushing "through the roof" until something gives. That something may be one (or both) of two factors: (1) the price of gold may be raised, allowing our gold reserve base to rise in value, thereby taking temporary pressure off the defense of the dollar via interest rates. (2) A business collapse could temporarily take the pressure off interest rates via a decline in demand for money.



Of course, a third possible course would be a termination of the Vietnam war, a sur-tax, and a vast cut in Government spending. The likelihood of these three occurring is so slim, however, as to be outside the realm of serious consideration.

But given a continuation of the present course of events, I would expect the discount rate to stay high (even going higher), while interest rates continue to push towards prohibitive levels. As to the actual trend of interest rates in the all-important short-term market, we can turn to the next chart.

The 91-day U.S. Treasury bills were first offered in 1937. From the $\frac{1}{4}$ of 1% rate of 1937, the bills pushed above the 2% level under the strain of the Korean war. The 1953 recession brought the bills back below 1% again, but during the 1955-56 boom the bill rate jumped to above 3%. Again the rate was brought back sharply during the 1957 recession. The Fed, in 1958, realizing that it had overdone the money ease, reversed itself and the bills shot to above 4% in 1959-60. During the short-lived 1960 recession the bills drifted back to the above-2% level, but it was here that the gold outflow and new massive U.S. deficits appeared. Slowly but steadily, aggravated by gigantic Federal deficit spending, the bills moved upward in yield.

In September, 1966, the bill rate careened to a record 5.58% as the famous "money crunch" took hold. Again the Fed sought to bring the rate down, but this time the bill yields dropped to 3.5%, then turned up again. In the face of the worst gold losses in history and under order from our creditors to eliminate the deficit while tightening our money rates, the bill rate last week rose to 5.54%, only slightly below the record 1966 level.

Thus the second "fever chart," the yield on the bellwether of the short-term money market, is pointing to a hot time ahead. It has been said that the economy can adjust to any steady level of money rates, but it's the change in rates which makes the change in psychology. Thus not too much is being said about today's money rates which are approximately those which frightened investors in 1966. I would guess that the bill rate would have to go to new highs around 6% to bring chaotic conditions

to the economy. We will watch and see whether new highs in the rates are forthcoming.

QUOTES OF NOTE: From the latest Commercial and Financial Chronicle's weekly article by economist Dr. Paul Einzig: "I have been forecasting various devaluations for nearly fifty years, and I have not been wrong once. I'm now convinced more firmly than I have ever been before that the pound will either be devalued once more or it will be allowed to float downward. And I've never been more certain about any of my devaluation forecasts in the past than about my present forecast that the pound will be devalued. I am prepared to stake my whole reputation built up over nearly half a century on this."

From the April 29 issue of Indicator Digest: "To put it another way, one out of every two families is now in the market, compared to one out of twenty in the frenzied year 1929. To all of those who have also read Baruch's Madness of Crowds, and who know how mob psychology can work in the type of panic this generation has never seen, these are pretty frightening facts of life."

From the April 24 Janeway Service by Elliot Janeway: "The War Prospect. Altogether, the prospect is now for the war to drag on just about as it was— for the first time unrelieved by interim spurts in popular enthusiasm about 'winning.' On reflection, all this may not seem as strange as it admittedly sounds at first blush. After all, just about everything else has been subjected to upset so far this year. What's so new and different about our fighting the same kind of war we have been fighting as an exercise in peace-making? Agreement on a 'reasonable' talk site won't change this prospect."

From the April 24 Neill Letters of Contrary Opinion: "First of all, the problems to come up post-Viet-Nam are heavily weighted with emotions. Decisions will be made emotionally rathern than objectively, sentimentally instead of sensibly, temperamentally rathern than realistically.

> Question One: What are the problems discussed today other than Viet-Nam; are they not all emotional questions, including slums, ghettoes, drugs, racism, 'crisis of the cities,' education, the generation gap, and so on?
>
> Question Two: In one word, what is the remedy? Answer — MONEY."

From the April 24 Christian Science Monitor: "Dr. Arthur F. Burns, chairman of the Council of Economic Advisers during President Eisenhower's first term, says an increase in the official price of gold 'may be the wisest course open' to the United States.

"He has a big 'if' attached—if the U.S. is 'unwilling to practice austerity on a sufficient scale.' But,in view of prevailing political sentiment, Dr. Burns says he doubts that the government will practice monetary and fiscal austerity on either the scale needed or over a long enough time to subdue inflationary expectations and restore full confidence in American financial policy."

From John Gerrity's article in the April 22 Weekly Bond Buyer: "The best indications are that Congress, in its return to the Capital this week after its long, business-as-usual, Easter Holiday, will continue to display its lemming-like search for the cliff's edge. With the nation still at war, with near-anarchy in many urban areas, and with the nation's prosperity, solvency, and currency imperilled, Congress still casts a baleful eye at its plight of being in a situation that demands decisions of men who cannot comprehend the issues which need deciding."

* * * *

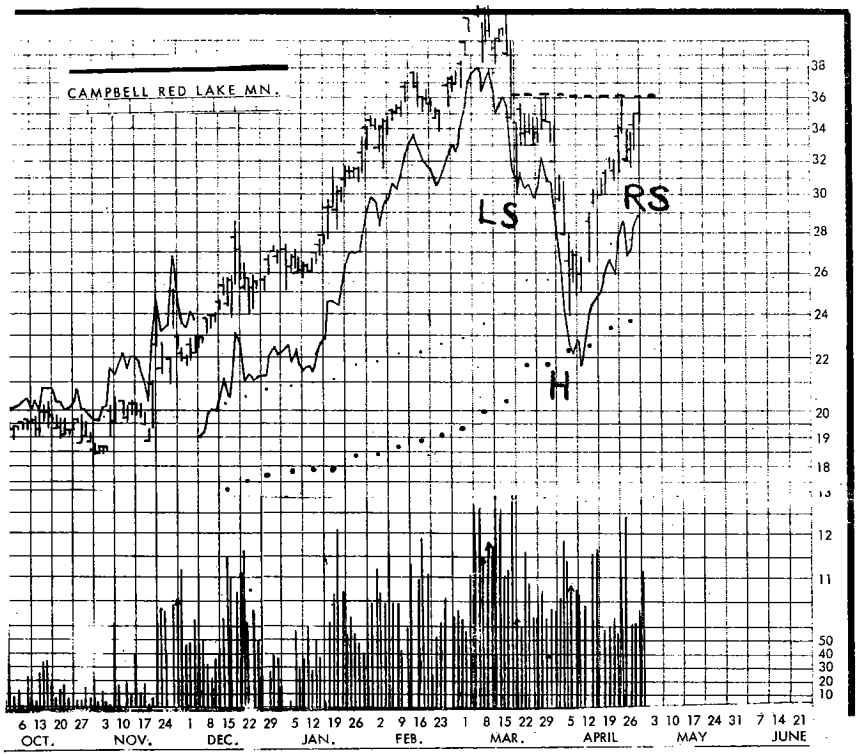
The Treasury Department finally released the latest figures on our gold losses. During the month of March the U.S. lost a record $1.97 billion in gold, raising the total drain stemming from the recent gold crisis to more than $2 billion.

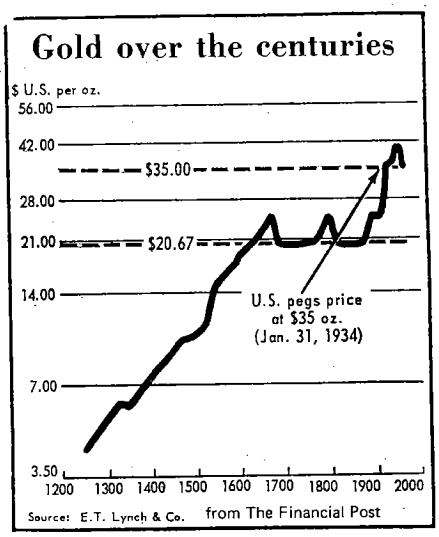
At the same time, it was reported that America's trade with the rest of the world shockingly turned to a deficit for the first time in five years. Exports plunged 11.5% while imports rose .4%, to provide a deficit of $157 million. Talk is increasing regarding the current "overvalued" status of the dollar. This is a polite way of saying that inflation in this country has priced our goods out of the world market.

In the face of this, one wonders how much longer the European Central bankers will hold off calling in our gold for dollars. Speaking of gold, I thought this little chart (see page 6) was well worth publishing. It shows that the price of gold (subject to minor run-ups and corrections) has gone only one way since the year 1225— and that way is up. Is it any wonder the investors and speculators are hoarding gold now at $38 per ounce? With a "floor" around $35.80, it's a play with a floor and no ceiling during one of the greatest inflationary periods of the Century.

Says Harry Schultz in his latest report, "Those who don't understand gold (a majority) refer to the hoarding of gold as if hoarding was immoral. What they fail to realize is that they also hoard. They hoard paper money. So hoarding is not of itself to be attacked. It is then up to you to decide which you prefer to hoard—paper dollars (pounds or other unbacked money) or the backing itself."

On April 26 the spread between the yield on the Dow Average and the yield on Barron's 10 Highest-Grade Bonds rose to an all-time record of 3.14%. Thus the current rally in stocks together with the weakness in bonds has produced an historically abnormal (and bearish) spread. This indicator is shouting "danger."





CAMPBELL RED LAKE: In Letter 384 (Lab. page) I discussed the appearance of numerous "head-and-shoulder" tops in individual stocks. These tops preceded the last market decline to the March lows.

I believe it is particularly significant that the four major listed gold shares (i.e., Dome, Campbell Red Lake, American-South African and Homestake) have now formed what appears to be head-and-shoulder bottoms. While no formation is foolproof, there does (cont. below)

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seem to be a good chance that the current patterns in the golds are preceding a new move by the gold shares—perhaps to the old highs or to new highs. This is particularly possible since the S. African gold index (see page 1 composite chart) closed at 84.2 on April 26, just a few points from its 1968 high. Thus it would seem that strength has come to the S. African shares first and this strength is now ready to appear in the listed gold shares on the N.Y.S.E. (just the opposite of what occurred in the last gold rise).

I find the potential gold formations interesting since they have come in the face of the recent "good news" about S.D.R.'s, the possibility of a tax rise and the renewed talk about eliminating the budget deficit. Perhaps the gold shares are saying that that is just what it is—"talk."

The chart of Campbell (CRK) is typical of the listed gold charts (daily chart courtesy of Traders Research, 101 Cherry St., Alton, Ill 62002). Here we see the first plunge below the "neckline" or resistance level. This first plunge (LS on chart) constituted the Left Shoulder. The second plunge to the low at 24 formed the Head (H). Then the stock rose all the way back to the neckline at 36. The most recent minor decline formed the Right Shoulder (RS) in Campbell. According to technical theory, a new rise above 36 (particularly on increasing volume) would complete the reversal to the upside and send the stock substantially higher.

The great size of the CRK formation (the distance from the neckline to the low of the Head, 36 to 24) offers a suggestion that if the stock breaks out above 36, the rise could be large—easily to new highs. As a rule, the greater the "count" from the neckline to the low formed by the head, the greater the rise on an upside breakout above the neckline.